Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Access Charge Reform	)	CC Docket No. 96-262
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
Transport Rate Structure and Pricing	)	CC Docket No. 91-213
	)	
End User Common Line Charges	)	CC Docket No. 95-72
	)	

FIRST REPORT AND ORDER

Adopted: May 7, 1997 **Released:** May 16, 1997

Comment Date: June 26, 1997
Reply Date: July 11, 1997

By the Commission: Commissioners Quello, Ness, and Chong issuing separate statements.

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I. INTRODUCTION

1. In passing the Telecommunications Act of 1996 (the 1996 Act),[1] Congress sought to establish "a pro-competitive, deregulatory national policy framework" for the United States' telecommunications industry. With this Order, we begin the third part in a trilogy of actions collectively intended to foster and accelerate the introduction of competition into all telecommunications markets, pursuant to the mandate of the 1996 Act.

2. In the *Local Competition Order*,[2] we set forth rules to implement section 251 and section 252 of the Communications Act of 1934, as amended. As with all of Part II of Title II of the Communications Act, those sections, and the rules implementing them, seek to remove the legal, regulatory, economic, and operational barriers to telecommunications competition. Among other things, sections 251 and 252 provide entrants with the opportunity to compete for consumers in local markets by either constructing new facilities, leasing unbundled network elements, or reselling telecommunication services.

3. In the *Universal Service Order*,[3] which we adopt in a companion order today, we take steps to ensure that support mechanisms that are necessary to maintain local rates at affordable levels are protected and advanced as local telecommunication markets become subject to the competitive pressures unleashed by the 1996 Act. When it enacted section 254 of the Communications Act, Congress detailed the principles that must guide this effort. It placed on the Commission and the states the duty to implement these principles in a manner consistent with the pro-competition purposes of the Act, as embodied in, for instance, the interconnection provisions of the Act.[4] It stated that "[t]here should be specific, predictable and sufficient Federal and State mechanisms to preserve and advance universal service."[5]

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[1] Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (codified at 47 U.S.C. §§ 151 *et. seq.*) (1996 Act).

[2] Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, CC Docket No. 96-98, First Report and Order, 11 FCC Rcd 15499 (1996) (*Local Competition Order*), Order on Reconsideration, CC Docket No. 96-98, 11 FCC Rcd 13042 (1996), *petition for review pending and partial stay granted, sub nom.* Iowa Utils. Bd. v. FCC, 109 F.3d 418 (8th Cir. 1996).

[3] Federal-State Board on Universal Service, CC Docket No. 96-45, First Report and Order, FCC 97-157 (rel. May 8, 1997) (*Universal Service Order*).

[4] *See* 47 U.S.C. §§ 251-252.

[5] 47 U.S.C. § 254(b)(5).

4. Congress also specified that universal service support "should be explicit," and that, with respect to federal universal service support, "[e]very telecommunications carrier that provides interstate telecommunications services shall contribute, on an equitable and non-discriminatory basis, to the specific, predictable, and sufficient mechanisms established by the Commission to preserve and advance universal service."[6] As explained further in the Joint Explanatory Statement of the Committee of the Conference, Congress intended that, "[t]o the extent possible, . . . any support mechanisms continued or created under new section 254 should be explicit, rather than implicit as many support mechanisms are today."[7] Congress directed the Commission, by May 8, 1997, to complete a universal service proceeding that "include[s] a definition of the services that are supported by Federal universal service support mechanisms and a specific timetable for implementation."[8]

5. Through our accompanying *Universal Service Order*, we establish the definition of services to be supported by federal universal service support mechanisms and the specific timetable for implementation. Further, through this *First Report and Order* in our access reform docket and our *Universal Service Order*, we set in place rules that will identify and convert existing federal universal service support in the interstate high cost fund, the dial equipment minutes (DEM) weighting program, Long Term Support, Lifeline, Link-up, and interstate access charges to explicit federal universal service support mechanisms. As detailed below, we will identify the implicit federal universal service support currently contained in interstate access charges through three methods.

6. First, we will reduce usage-sensitive interstate access charges by phasing out local loop and other non-traffic-sensitive (NTS) costs from those charges and directing incumbent local exchange carriers (LECs) to recover those NTS costs through more economically efficient, flat-rated charges. Because NTS costs, by definition, do not vary with usage, the recovery of NTS costs on a usage basis pursuant to our current access charge rules amounts to an implicit subsidy from high-volume users of interstate toll services to low-volume users of interstate long-distance services.

7. Second, we will rely in part on emerging competition in local telecommunications markets, spurred by the adoption of the 1996 Act, to help identify the differences between the rates for interstate access services established by incumbent LECs under price cap regulation and those that competition would set. The prices for interstate access services offered by competing providers presumably will not contain any implicit universal service support such

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[6] 47 U.S.C. § 254(d)-(e).

[7] Joint Explanatory Statement of the Committee of the Conference, S. CONF. REP. NO. 230, 104th Cong., 2d Sess. 131 (1996) (Joint Explanatory Statement).

[8] 47 U.S.C. § 254(a)(2).

as that embedded in the incumbent LECs' access charges. Consequently, the introduction of competition inevitably will help to remove implicit support from the incumbent LECs' access charges where competition develops and also will help to identify the extent of implicit support in other areas.

8. Third, we will engage in further deliberations on a forward-looking economic cost-based mechanism that we will use to distribute federal support to rural, insular, and high cost areas, beginning in 1999. Based on cost studies the states will conduct during the coming year (or, at a state's election, based upon Commission-developed proxy methods), an estimate of the forward-looking economic cost of providing service to a customer in a particular rural, insular, or high cost area will be calculated. We will distribute federal universal service support based on the interstate portion of the difference between forward-looking economic cost and a nationwide revenue benchmark. The amount of the support will be explicitly calculable and identifiable by competing carriers, and the support will be portable among competing carriers, *i.e.*, distributed to the eligible telecommunications carrier chosen by the customer. It will be funded by equitable and non-discriminatory contributions from all carriers that provide interstate telecommunications services. Through this *First Report and Order*, we direct that federal universal service support received by incumbent LECs be used to reduce or satisfy the interstate revenue requirement otherwise collected through interstate access charges. Accordingly, through both our *Universal Service Order* and this *First Report and Order* on access reform, interstate implicit support for universal service will be identified and removed from interstate access charges, and support will be provided through the explicit interstate universal service support mechanisms.

9. Although these three steps will set in motion a process that will remove implicit universal service support from access charges, it will not remove all implicit support from all access charges immediately. This result is fully in accord with Congress's directives. Although Congress said in the Act that "support *should be* explicit" (emphasis added), it did not provide that support *shall be* explicit.[9] Congress's decision to say "should" instead of "shall" is especially pertinent in light of Congress's repeated use of "shall" in the 1996 Act.[10] Moreover, in the Act's legislative history, Congress qualified its intention that "support mechanisms should be explicit, rather than implicit," with the phrase "[t]o the extent possible."[11] Thus, Congress recognized that the conversion of the existing web of implicit subsidies to a system of explicit support would be a difficult task that probably could not be accomplished immediately. As explained below, we conclude that a process that eliminates

[9] 47 U.S.C. § 254(e).

[10] *See* Joseph Farrell, *Creating Local Competition*, 49 Fed. Comm. L.J. 201, 211 (1996) ("shall" appears 2,036 times in 1996 Act, according to staff analysis).

[11] Joint Explanatory Statement at 131.

implicit subsidies from access charges over time is warranted primarily for three reasons. First, we simply do not have the tools to identify the existing subsidies precisely at this time. Second, we prefer to rely on the market rather than regulation to identify implicit support because we are more confident of the market's ability to do so accurately. Third, even if we were more confident of our ability to identify all of the existing implicit support mechanisms at this time, eliminating them all at once might have an inequitable impact on the incumbent local exchange carriers.

10. Nor, by our orders today, do we attempt to identify or eliminate the implicit universal service support mechanisms established by state commissions. We recognize that states are initially responsible for identifying implicit intrastate subsidies. For the reasons stated above, we believe the Commission has discretion under the statute to employ pro-competitive, deregulatory policies to aid in the reform of the existing, complex system of universal service. Where pro-competition policies, such as those set forth in sections 251, 252 and 253, can force prices for telecommunications services to competitive levels, and, as a result, eliminate or, at least, substantially eliminate implicit support, the Act grants us the authority to rely on such policies over a period of time. We find that the Act does not require, nor did Congress intend, that we immediately institute a vast set of wide-ranging pricing rules applicable to interstate and intrastate services provided by incumbent LECs that would have enormously disruptive effects on both ratepayers as well as the affected LECs. Indeed, the congressional mandate that we implement pro-competitive, deregulatory policies is a continuing reminder that, wherever feasible, we should select competition instead of regulation as our means of accomplishing the stated statutory goals. Reliance on competition is the keystone that unifies our universal service and access reform orders.

11. Nevertheless, implicit intrastate universal service support is substantial. States have maintained low residential basic service rates through, among other things, a combination of: geographic rate averaging, high rates for business customers, high intrastate access rates, high rates for intrastate toll service, and high rates for vertical features and services such as call waiting and call forwarding. By not mandating immediate Commission action to eliminate these policies and instead by ordering that the Commission and the states together achieve universal service goals,[12] Congress intended that states, acting pursuant to sections 254(f) of the Communications Act, must in the first instance be responsible for identifying intrastate implicit universal service support. Indeed, by our decisions in this Order and in our companion *Universal Service Order*, we strongly encourage states to take such steps.

12. To achieve the vital, historic, and congressionally-mandated purposes of universal service in every state in an era in which competition replaces monopoly, it is necessary that the states and the Commission develop new and effective mechanisms of complementing the

[12] *See* 47 U.S.C. § 254.

activities of each other. Therefore, as states implement their universal service plans, we will be able to assess whether additional federal universal service support is necessary to ensure that quality services remain "available at just, reasonable, and affordable rates."[13] Our decisions in this Order are meant in part to provide some elements of the plan and time sufficient to discharge responsibly an aspect of the federal role in this federal-state universal service partnership.

13. In this *First Report and Order*, we also take the actions necessary to permit the market, in the first instance, to expose any implicit universal service support that we may fail to identify as we implement our federal mechanisms for supporting universal service in insular, rural, and high cost areas and to drive access rates toward levels that competition would be expected to produce. Our decision also fulfills the congressional intent that we eliminate the rules that have helped to sustain *de facto* or *de jure* monopolies in access markets and instead create the conditions for competitive entry on a sustainable, long-term basis. That requires, among other things, that we phase out opportunities for inefficient entry that are created primarily by anomalies in the current, monopoly-oriented regime. Consequently, this Order sets forth a plan for removing distortions and inefficiencies in both the current "rate structures" (the term used to describe the manner in which a particular charge is assessed, such as through a per-minute-of-use fee or a flat-rated fee) and "rate levels" (the term used to describe the aggregate size of a particular access charge). By rationalizing the access charge rate structure, we ensure that charges more accurately reflect the manner in which the costs are incurred, thereby facilitating the movement to a competitive market. We also establish, in this *First Report and Order*, a prescriptive mechanism to ensure that, through the operation of price caps and by other means, interstate access charges in areas where competition does not develop will also be driven toward the levels that competition would be expected to produce. The *Price Cap Fourth Report and Order,*[14] which is also the Second Report and Order in this docket and which is also adopted today, modifies the X-Factor in accordance with this plan.

14. In a subsequent order in the present docket, we will provide detailed rules for implementing the market-based approach that we adopt in today's Order. That process will give carriers progressively greater flexibility in setting rates as competition develops, gradually replacing regulation with competition as the primary means of setting prices and facilitating investment decisions. A separate order in this docket will also address "historical cost" recovery: whether and to what extent carriers should receive compensation for the

[13] 47 U.S.C. § 254(b)(1).

[14] Price Cap Performance Review for Local Exchange Carriers, Fourth Report and Order in CC Docket No. 94-1, and Access Charge Reform, Second Report and Order in CC Docket No. 96-262, FCC 97-159 (adopted May 7, 1997) (*Price Cap Fourth Report and Order*).

recovery of the allocated costs of past investments if competitive market conditions prevent them from recovering such costs in their charges for interstate access services.

15. By our orders today, we reject the arguments made by some parties that section 254 compels us immediately to remove all universal service costs from interstate access charges.[15] Making "implicit" universal service subsidies "explicit" "to the extent possible" means that we have authority at our discretion to craft a phased-in plan that relies in part on prescription and in part on competition to eliminate subsidies in the prices for various products sold in the market for telecommunications services. Moreover, we have met section 254's clear command that we identify the services to be supported by federal universal service support mechanisms and that we establish a specific timetable for implementation. Under that timetable, we will over the next year identify implicit interstate universal support and make that support explicit, as further provided by section 254(e).[16]

16. Coupled with the modifications implemented in our *Universal Service Order*, the changes we put in place today will provide far-reaching benefits to the American people. This Order will restructure access charges, resulting in lower long-distance rates for many consumers, while substantially increasing the volume of long-distance calling. It will promote the spread of competition by replacing significant implicit subsidies with an explicit and secure universal service support system. It will foster competition and economic prosperity by creating an access charge system that is both efficient and fair. We believe that the changes implemented by this Order are necessary to meet the goal set forth in the 1996 Act -- "opening all telecommunications markets to competition."[17]

A. Background

1. The Existing Rate System

17. For much of this century, most telephone subscribers obtained both local and long-distance services from the same company, the pre-divestiture Bell System, owned and operated by AT&T. Its provision of local and intrastate long-distance services through its wholly-owned operating companies was regulated by state commissions. The Commission regulated AT&T's provision of interstate long-distance service. Much of the telephone plant

[15] *See* Appendix B, Section IV.A.

[16] As with any implicit support mechanism, universal service costs are presently intermingled with all other costs, including the forward-looking economic costs of interstate access and any historic costs associated with the provision of interstate access services. We cannot remove universal service costs from interstate access charges until we can identify those costs, which we will not be able to do even for non-rural LECs before January 1, 1999.

[17] Joint Explanatory Statement at 1.

that is used to provide local telephone service (such as the local loop, the line that connects a subscriber's telephone to the telephone company's switch) is also needed to originate and terminate interstate long-distance calls. Consequently, a portion of the costs of this common plant historically was assigned to the interstate jurisdiction and recovered through the rates that AT&T charged for interstate long-distance calls. The balance of the costs of the common plant was assigned to the intrastate jurisdiction and recovered through the charges administered by the state commissions for intrastate services. The system of allocating costs between the interstate and intrastate jurisdictions is known as the separations process. The difficulties inherent in allocating the costs of facilities that are used for multiple services between the two jurisdictions are discussed below.

18. At first, there was no formal system of tariffed charges to determine how the BOCs and the hundreds of unaffiliated, independent LECs would recover the costs allocated to the interstate jurisdiction by the separations rules. Instead, AT&T remitted to these companies the amounts necessary to recover their allocated interstate costs, including a return on allocated capital investment.

19. In the 1970s, MCI and other interexchange carriers (IXCs) began to provide switched long-distance service in competition with AT&T. However, AT&T still maintained monopolies in the local markets served by its local subsidiaries, the Bell Operating Companies (BOCs). The BOCs owned and operated the telephone wires that connected the customers in their local markets. Other independent (non-Bell) LECs held similar monopoly franchises in their local service areas. MCI and the other IXCs were dependent on the BOCs and the independent LECs to complete the long-distance calls to the end user.

20. For much of the 1970s, MCI and AT&T fought over the fees -- the access charges -- that MCI should pay the BOCs for originating and terminating interstate calls placed by or to end users on the BOCs' local networks. That battle took place before federal regulators, as well as in the federal courts. In December 1978, under Commission supervision, AT&T, MCI, and the other long-distance competitors entered into a comprehensive interim agreement, known as Exchange Network Facilities for Interstate Access (ENFIA), that set rates that AT&T would charge long-distance competitors for originating and terminating interstate traffic over the facilities of its local exchange affiliates.[18] Several years afterwards, AT&T's divestiture was completed, separating the local exchange operations of the BOCs from the rest of AT&T's operations, including AT&T's long distance business. The BOCs maintained monopoly franchises in their local market, but by splitting them off from AT&T's long-distance business, the federal courts removed an incentive for the BOCs to favor AT&T's long distance business over its competitors. Now AT&T competed

[18] For additional background on the ENFIA agreement, *see, e.g.*, Investigation of Access and Divestiture-Related Tariffs, CC Docket No. 83-1145, Phase I and Phase II, Part 1, FCC 85-100, 57 Rad.Reg.2d 1229, 1241 (rel. March 8, 1985).

directly with MCI and the other competitors to provide interstate service, and all of the competitors paid the BOCs for the service of providing the necessary access to end users.

21. In 1978, the Commission commenced a wide-ranging review of the system by which LECs were compensated for originating and terminating interstate traffic. In 1983, following the decision to break-up AT&T, the Commission adopted uniform access charge rules in lieu of earlier agreements.[19] These rules governed the provision of interstate access services by all incumbent LECs, BOCs as well as independents. The access charge rules provide for the recovery of the incumbent LECs' costs assigned to the interstate jurisdiction by the separations rules.

22. The Commission uses a multi-step process to identify the cost of providing access service. First, the rules require an incumbent LEC to record all of its expenses, investments, and revenues in accordance with accounting rules set forth in our regulations.[20] Second, the rules divide these costs between those associated with regulated telecommunications services and those associated with nonregulated activities.[21] Third, the separations rules determine the fraction of the incumbent LEC's regulated expenses and investment that should be allocated to the interstate jurisdiction.[22] After the total amount of interstate cost is identified, the access charge rules translate these interstate costs into charges for the specific interstate access services and rate elements. Part 69 specifies in detail the rate structure for recovering those costs. That is, the rules tell the incumbent LECs the precise manner in which they may assess charges on interexchange carriers and end users.

23. Determining the costs that an incumbent LEC incurs to provide interstate access services and that, consequently, should be recovered from those services, is relatively straightforward in some cases and problematic in others. Some facilities, such as private lines, can be used exclusively for interstate services and, in such cases, the entire cost of those facilities is assigned to the interstate jurisdiction by the separations rules. Most facilities, however, are used for both intrastate and interstate services. The costs of some of these facilities vary depending on the amount of telecommunications traffic that they handle. The separations rules typically assign these traffic-sensitive (TS) costs on the basis of the relative interstate and intrastate usage of the facilities, as measured, for example, by the relative minutes of interstate and intrastate traffic carried by such facilities. By contrast, the costs of

[19] MTS and WATS Market Structure, Third Report and Order, CC Docket No. 78-72, Phase 1, 93 FCC 2d 241, *recon.*, 97 FCC 2d 682 (1983), *second recon.*, 97 FCC 2d 834 (1984).

[20] These rules are referred to as the Uniform System of Accounts and are contained in Part 32 of the Commission's Rules. *See* 47 C.F.R. §§ 32.1-.9000.

[21] This is governed by Sections 64.901-.904 of our Rules. *See* 47 C.F.R. §§ 64.901-.904.

[22] This step is governed by Part 36 of the Rules. See 47 C.F.R. §§ 36.1-.741.

other facilities used for both interstate and intrastate traffic do not vary with the amount of traffic carried over the facilities, *i.e.*, the costs are non-traffic-sensitive. These costs pose particularly difficult problems for the separations process: The costs of such facilities cannot be allocated on the basis of cost-causation principles because all of the facilities would be required even if they were used only to provide local service or only to provide interstate access services. A significant illustration of this problem is allocating the cost of the local loop, which is needed both to provide local telephone service as well as to originate and terminate long-distance calls. The current separations rules allocate 25 percent of the cost of the local loop to the interstate jurisdiction for recovery through interstate charges.[23]

24. The Commission has recognized in prior rulemaking proceedings that, to the extent possible, costs of interstate access should be recovered in the same way that they are incurred, consistent with principles of cost-causation. Thus, the cost of traffic-sensitive access services should be recovered through corresponding per-minute access rates. Similarly, NTS costs should be recovered through fixed, flat-rated fees. The Commission, however, has not always adopted rules that are consistent with this goal. In particular, the Commission limited the amount of the allocated interstate cost of a local loop that is assessed to residential and business customers as a flat monthly charge, because of concerns that allowing the flat charges to rise above the specified limits might cause customers to disconnect their telephone service. The residual cost of the loop not recovered from end users through the flat charge is recovered through a per-minute-of-use charge assessed to long-distance carriers.

25. Through the end of 1990, the vast majority of access revenues were governed by "cost-of-service" regulation. Under cost-of-service regulation, incumbent LECs calculate the specific access charge rates using projected costs and projected demand for access services.[24] Thus, for example, if an incumbent LEC projects that it will provide 10,000 total minutes of switching for interstate calls and estimates that it must generate $1,000 dollars in revenue in order to recover the costs of switching that are allocated to the interstate jurisdiction by the separations rules, the access charge for local switching would be set at $0.10 per minute ($1,000/10,000 minutes). In 1991, however, we implemented a system of price cap regulation that altered the manner in which the largest incumbent LECs established their interstate access charges. While most rural and small LECs remained subject to all of the Part 69 cost-of-

[23] The general process of separating these costs between the interstate and intrastate jurisdictions is discussed by the Supreme Court in *Smith v. Illinois Bell Tel. Co.*, 282 U.S. 133 (1930).

[24] Since 1981, the Commission has allowed certain smaller incumbent LECs to base their access rates on historic, rather than projected, cost and demand. *See* 47 C.F.R. § 61.39.

service rules, generally the largest incumbent LECs[25] are now subject to price cap regulations set forth in Part 61 of our rules.

26. Price cap regulation fundamentally alters the process by which incumbent LECs determine the revenues they are permitted to obtain from interstate access charges for access services. Briefly stated, cost-of-service regulation is designed to limit the profits an incumbent LEC may earn from interstate access service, whereas price cap regulation focuses primarily on the prices that an incumbent LEC may charge and the revenues it may generate from interstate access services. Under the Part 69 cost-of-service rules, revenue requirements are based on embedded or accounting costs allocated to individual services. Incumbent LECs are limited to earning a prescribed return on investment and are potentially obligated to provide refunds if their interstate rate of return exceeds the authorized level. By contrast, although the access charges of price cap LECs originally were set at the cost-of-service levels that existed at the time they entered price caps, their prices have been limited ever since by price indices that have been adjusted annually pursuant to formulae set forth in our Part 61 rules. Price cap carriers whose interstate access charges are set by these pricing rules are permitted to earn returns significantly higher than the prescribed rate of return that incumbent LECs are allowed to earn under cost-of-service rules. Price cap regulation encourages incumbent LECs to improve their efficiency by harnessing profit-making incentives to reduce costs, invest efficiently in new plant and facilities, and develop and deploy innovative service offerings, while setting price ceilings at reasonable levels.[26] In this way, price caps act as a

[25] The Commission required price cap regulation for the BOCs and GTE, and permitted other LECs to adopt price cap regulation voluntarily, provided that all their affiliates also convert to price cap regulation and that they withdraw from the NECA pools. Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, CC Docket No. 87-313, 5 FCC Rcd 6786, 6818-20 (1990) (*LEC Price Cap Order*). Currently, the price cap LECs serve more than 92 percent of the total access lines, based on LECs' 1995 and 1996 Annual Access Tariffs filed with the Commission, and account for almost 91 percent of the total interstate revenues for access services, *see* Universal Service Fund Data Collection, CC Docket No. 80-286, Universal Service Fund 1996 Submission of 1995 Study Results by NECA, Oct. 1, 1996.

[26] The price cap regulations also give incumbent LECs greater flexibility in determining the amount of revenues that may be recovered from a given access service. The price cap rules group services together into different baskets, service categories, and service subcategories. The rules then identify the total permitted revenues for each basket or category of services. Within these baskets or categories, incumbent LECs are given some discretion to determine the portion of revenue that may be recovered from specific services. Subject to certain restrictions, this flexibility allows incumbent LECs to alter the access charge rate level associated with a given service. For example, within the category of switching services, an incumbent LEC may choose to recover a greater portion of its switching revenues through access charges assessed to one kind of switching service rather than through charges assessed to another switching service. Although the LEC must still observe the switched-access rate structure that is set forth in Part 69 of our rules (which determines what services may be offered and whether charges may be imposed on a per-minute or flat-rated basis), the rate level of the access charge will vary depending on the amount of revenues that the LEC chooses to recover from a given service.

transitional regulatory scheme until the advent of actual competition makes price cap regulation unnecessary.[27]

27. Although price cap regulation eliminates the direct link between changes in allocated accounting costs and change in prices, it does not sever the connection between accounting costs and prices entirely. The overall interstate revenue levels still generally reflect the accounting and cost allocation rules used to develop access rates to which the price cap formulae were originally applied. Price cap indices are adjusted upwards if a price cap carrier earns returns below a specified level in a given year. Moreover, a price cap LEC may petition the Commission to set its rates above the levels permitted by the price cap indices based on a showing that the authorized rate levels will produce earnings that are so low as to be confiscatory. In the past, all or some price cap LECs were required to "share," or return to ratepayers, earnings above specified levels. The new rules adopted in the companion *Price Cap Fourth Report and Order* remove this limit on the maximum returns that can be earned by price cap incumbent LECs.

2. Implicit Subsidies in the Existing System

28. Both our price cap and cost-of-service rules contain requirements that inevitably result in charges to certain end users that exceed the cost of the service they receive. To the extent these rates do not reflect the underlying cost of providing access service, they could be said to embody an implicit subsidy. Some of these subsidies are due to the rate structures prescribed by our rules, which in some cases prevent incumbent LECs from recovering their access costs in the same way they have been incurred. For example, although the cost of the local loop that connects an end user to the telephone company's switch does not vary with usage, the current rate structure rules require incumbent LECs to recover a large portion of these non-traffic-sensitive costs through traffic-sensitive, per-minute charges. These mandatory recovery rules inflate traffic-sensitive usage charges and reduce charges for connection to the network, in essence creating an implicit support flow from end users that make many interstate long-distance calls to end users that make few or no interstate long-distance calls.

29. Several Federal-State Joint Boards have observed that additional subsidies and distortions may be due, not only to the rate structure, but to the separations rules that divide costs between the interstate and intrastate jurisdictions. For example, the current separations rules require larger incumbent LECs to allocate the costs of their switching facilities between the interstate and intrastate jurisdictions on the basis of relative use (*i.e.*, if 30 percent of the minutes of use handled by the LEC's switching facilities are interstate long-distance calls, 30

[27] Price Cap Performance Review for Local Exchange Carriers, Second Further Notice of Proposed Rulemaking in CC Docket No. 93-124, and Second Further Notice of Proposed Rulemaking in CC Docket No. 93-197, 11 FCC Rcd 858, 862 (1995) (*Price Cap Second FNPRM*) .

percent of the LEC's switching costs are allocated to the interstate jurisdiction and recovered through interstate access charges). Our rules, however, permit smaller incumbent LECs to allocate a greater share of their switching costs to interstate access services than would result from the relative use allocator. These smaller incumbent LECs multiply the interstate use ratio by a factor (as high as 3) specified in the separations rules. In its *Recommended Decision*, the Joint Board on Universal Service observed that these separations rules "shift what would otherwise be intrastate costs to the interstate jurisdiction,"[28] thereby allowing such LECs to charge lower prices for intrastate services. Similarly, in the *Marketing Expense Recommended Decision*, another Federal-State Joint Board observed that the separations rules allocate a share of the incumbent LECs' retail marketing expenses to the interstate jurisdiction that is unreasonably high, given that the interstate access services consist primarily of wholesale service offerings.[29] To the extent these and other separation rules do not apportion costs between the jurisdictions in a manner that reflects the costs incurred to provide service in each jurisdiction, they might be viewed as generating subsidies from the interstate to the intrastate jurisdiction. These subsidies effectively require incumbent LECs to charge higher rates for interstate services and lower rates for intrastate services than would otherwise occur if the subsidies were eliminated.

30. This "patchwork quilt of implicit and explicit subsidies"[30] generates inefficient and undesirable economic behavior. For example, a rate structure that requires the use of per-minute access charges where flat-rated fees would be more appropriate increases the per-minute rates paid by IXCs and long-distance consumers, thus artificially suppressing demand for interstate long-distance services. Similarly, the possible overallocation of costs to the interstate jurisdiction may, for some consumers, increase long-distance rates substantially, suppressing their demand for interstate interexchange services. Implicit subsidies also have a disruptive effect on competition, impeding the efficient development of competition in both the local and long-distance markets. For example, where rates are significantly above cost, consumers may choose to bypass the incumbent LEC's switched access network, even if the LEC is the most efficient provider. Conversely, where rates are subsidized (as in the case of consumers in high-cost areas), rates will be set too low and an otherwise efficient provider would have no incentive to enter the market. In either case, the total cost of

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[28] Federal-State Joint Board on Universal Service, CC Docket No. 96-45, Recommended Decision, 12 FCC Rcd 87, 187, ¶ 189 (rel. Nov. 8, 1996) (*Joint Board Recommended Decision*). The Joint Board found that this allocation structure, known as DEM (dial equipment minute) weighting, is "an implicit support mechanism that is recovered through the switched access rates charged to interexchange carriers by those carriers serving less than 50,000 lines." *Joint Board Recommended Decision* at 237, ¶ 292.

[29] Amendment of Part 67 (New Part 36) of the Commission's Rules and Establishment of a Federal-State Joint Board, CC Docket No. 86-297, Recommended Decision and Order, 2 FCC Rcd 2582 (1987) (*Marketing Expense Recommended Decision*).

[30] *Local Competition Order* at 15506, ¶ 5.

telecommunications services will not be as low as it would otherwise be in a competitive market. Because of the growing importance of the telecommunications industry to the economy as a whole, this inefficient system of access charges retards job creation and economic growth in the nation.

31. Despite the existence of distortions and inefficiencies, the current system of cross-subsidies has persisted for over a decade. The structure has been justified on policy grounds, principally as a means to serve universal service goals. By providing incumbent LECs with a stream of subsidized revenues from certain customers, the system allows regulators to demand below-cost rates for other customers, such as those in high-cost areas.

3. The Telecommunications Act of 1996

32. The existing system of implicit subsidies and support flows is sustainable only in a monopoly environment in which incumbent LECs are guaranteed an opportunity to earn returns from certain services and customers that are sufficient to support the high cost of providing other services to other customers. The new competitive environment envisioned by the 1996 Act threatens to undermine this structure over the long run. The 1996 Act removes barriers to entry in the local market, generating competitive pressures that make it difficult for incumbent LECs to maintain access charges above economic cost. For example, by giving competitors the right to lease an incumbent LEC's unbundled network elements at cost,[31] Congress provided IXCs an alternative avenue to connect to and share the local network. Thus, where existing rules require an incumbent LEC to set access charges above cost for a high-volume user, a competing provider of exchange access services entering into a market can lease unbundled network elements at cost, or construct new facilities, to circumvent the access charge.[32] In this way, a new entrant might target an incumbent LEC's high-volume access customers, for whom access charges are now set at levels significantly above economic cost. As competition develops, incumbent LECs may be forced to lower their access charges or lose market share, in either case jeopardizing the source of revenue that, in the past, has permitted the incumbent LEC to offer service to other customers, particularly those in high-

[31] 47 U.S.C. § 252(d)(1)(A)(i).

[32] In Section VI.A of this Order, we conclude that access charges may not be assessed on unbundled network elements since they are not part of the "cost" of providing those elements, as defined in 47 U.S.C. § 252(d)(1)(A)(i).

cost areas, at below-cost prices.[33] Incumbent LECs have for some time been claiming that this process has already made more than trivial inroads on their high-volume customer base.[34]

33. Recognizing the vulnerability of implicit subsidies to competition, Congress directed the Commission and the states to take the necessary steps to create permanent universal service mechanisms that would be secure in a competitive environment.[35] To achieve this end, Congress directed the Commission to strive to replace the system of implicit subsidies with "explicit and sufficient" support mechanisms.[36] In calling for explicit mechanisms, Congress did not intend simply to require carriers to identify and disclose the implicit subsidies that currently exist in the industry. Rather, as we determine in the *Universal Service Order* adopted today, Congress intended to establish subsidies that were both "measurable" and "portable" -- "measurable" in a way that allows competitors to assess the profitability of serving subsidized end users; and "portable" in a way that ensures that competitors who succeed in winning a customer also win the corresponding subsidy. A system of portable and measurable subsidies will permit carriers to compete for the subsidies associated with high-cost or low-income consumers. In the long run, this approach may even allow us to set subsidy levels through competitive bidding rather than through regulation. By contrast, under the current system of implicit subsidies, the only carriers that will serve high-cost consumers are those that are required to do so by regulation and that are able (because of their protected monopoly positions) to charge above-cost rates to other end users.

34. In the *Universal Service Order*, we establish "explicit and sufficient" support mechanisms to assist users in high-cost areas, low-income consumers, schools, and health care providers. By creating explicit support mechanisms, we establish a system to advance the universal service goals of the 1996 Act that is compatible with the development of competition in the local exchange and exchange access markets. By creating a portable and

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[33] *See, e.g.*, H. REP. NO. 204, 104th Cong., 1st Sess. 68 (1995) (The bill "would make such internal subsidies much less viable because deregulation would remove the near-guaranteed returns allowed in a regulated market, and with them the ability of the regulated firm to subsidize high-cost customers.") (Congressional Budget Office cost estimate).

[34] *See, e.g.*, Reply Comments of Bell Atlantic, CC Docket 94-1 (filed June 29, 1994) at 23-2 (citing attached Kahn Affidavit). *See also* John D. deButts, *An Unusual Obligation, in* HERITAGE AND DESTINY 422-32 (1983) (Address of AT&T Chairman to the National Association of Regulatory Utility Commissioners, September 20, 1973).

[35] *See, e.g.*, H. REP. NO. 204, 104th Cong., 1st Sess. 80 (1995) ("The Committee intends that this Joint Board should evaluate universal service in the context of a local market changing from one characterized by monopoly to one of competition.").

[36] *See* 47 U.S.C. § 254(e). *See also* Joint Explanatory Statement at 131 ("To the extent possible, the conferees intend that any support mechanisms continued or created under new section 254 should be explicit, rather than implicit as many support mechanisms are today.").

measurable system of subsidies, we utilize the power of the market to serve universal service goals more efficiently. That order, in short, guarantees that Congress's universal service goals are met in a way that conforms with the pro-competitive and deregulatory goals of the 1996 Act.

B. Access Charge Reform

35. In light of Congress's command to create secure and explicit mechanisms to achieve universal service goals, we conclude that implicit subsidies embodied in the existing system of interstate access charges cannot be indefinitely maintained in their current form. In this Order, therefore, we take two steps with respect to the rules governing the interstate access charges of price cap incumbent LECs.[37] First, we reform the current rate structure to bring it into line with cost-causation principles, phasing out significant implicit subsidies. Second, we set in place a process to move the baseline rate level toward competitive levels. Together with the *Universal Service Order*, these adjustments will promote the public welfare by encouraging investment and efficient competition, while establishing a secure structure for achieving the universal service goals established by law. Further, the process we set in place to achieve these goals avoids the destabilizing effects of sudden radical change, facilitating the transformation from a regulated to a competitive marketplace.

1. Rationalizing the Rate Structure

36. In this Order, we reshape the existing rate structure in order to eliminate significant implicit subsidies in the access charge system. To achieve that end, we make several modifications to ensure that costs are recovered in the same way that they are incurred. In general, NTS costs incurred to serve a particular customer should be recovered through flat fees, while traffic-sensitive costs should be recovered through usage-based rates. The present structure violates this basic principle of cost causation by requiring incumbent LECs to recover many fixed costs through variable, per-minute access rates. An important goal of this Order is to increase the amount of fixed costs recovered through flat charges and decrease the amount recovered through variable rates.

37. *Common Line Costs.* Because the costs of using the incumbent LEC's common line (or "local loop") do not increase with usage, these costs should be recovered through flat, non-traffic-sensitive fees. The current rate structure, however, generally allows an incumbent

[37] With the limited exceptions identified in Section V, the scope of this proceeding is limited to price cap incumbent LECs. As we explain in that section, the need for access reform is most immediate for these carriers, since they are most vulnerable to competition from interconnection and the availability of unbundled network elements. This proceeding will affect the vast majority of all access lines and revenues, because price cap regulation governs more than 90 percent of all incumbent LEC access lines. We will initiate a separate proceeding later this year to examine the special circumstances of small and rural rate-of-return LECs.

LEC to recover no more than a portion of its interstate common line revenues through a flat-rated Subscriber Line Charge (SLC), which is capped at $3.50 per month for residential and single-line business users, and $6.00 per month for multi-line users. The remaining common line revenues must be recovered through a per-minute Common Carrier Line (CCL) charge assessed on IXCs (which, in turn, may recover these charges through their prices to long-distance customers). In order to align the rate structure more closely with the manner in which costs are incurred, we adjust access rates over time until the common line revenues of all price cap LECs are recovered through flat-rated charges.

38. For primary residential and single-line business lines, however, we decline to implement this goal by increasing the SLC ceiling above its existing $3.50 level as urged by many companies, including price cap LECs and IXCs.[38] We do not wish to see increases in the price of basic dial tone charged by local exchange carriers to their end users for fear that such increases might cause some consumers to discontinue service, a result that would be contrary to our mandate to ensure universal service.[39] We agree with the Joint Board's finding that increasing the SLC ceiling may make telecommunications service unaffordable for some consumers.[40] Consequently, to the extent that common line revenues are not recovered through the customer's SLC, we conclude that LECs should recover these revenues through a flat, per-line charge assessed on the IXC to whom the access line is presubscribed -- the presubscribed interexchange carrier charge, or PICC.[41] Further, in order to provide IXCs with the opportunity to incorporate these changes into their business plans, we set the PICC for primary residential and single-line business lines at not more than the existing flat-rated line charges for the first year, and we gradually increase the ceiling thereafter until it reaches

[38] *See, e.g.*, BellSouth Corporation, BellSouth Telecommunications, Inc. (BellSouth) Comments, Attachment 2 at 20; GTE Service Corporation (GTE) Comments at 26-29, Reply at 20-21; Southwestern Bell Telephone Company (SWBT) Comments at 37-38, Reply at 8; U.S. West, Inc. (U S West) Reply at 27-28; Cincinnati Bell Telephone Company (Cincinnati Bell) Comments at 6-7; AT&T Corporation (AT&T) Comments 51-54, Reply at 25-26; Frontier Corporation (Frontier) Comments at 4, 5-7; Sprint Corporation (Sprint) Comments at 11-15; 50-51; Ad Hoc Telecommunications Users Committee (Ad Hoc) Reply at 4; General Services Administration/United States Department of Defense (GSA/DOD) Comments at 9-11, Reply at 5, 7; Tele-Communications, Inc. (TCI) Comments at 10; Reply at 4-5; Time Warner Communications Holdings, Inc. (Time Warner) Comments at 4-5; WinStar Communications, Inc. (WinStar) Comments at 4; WorldCom, Inc. (WorldCom) Comments at 30-31.

[39] Among the many goals announced in the 1996 Act, Congress declared that telephone service should be available at "affordable rates." 47 U.S.C. § 254(b)(1).

[40] *Joint Board Recommended Decision*, 12 FCC Rcd at 472, ¶ 769 (1996).

[41] Where an end user does not select a presubscribed interexchange carrier, we allow an incumbent LEC to collect this charge directly from the end user.

a level that permits full recovery of the common line revenues from flat charges assessed to both end users and IXCs.[42]

39. For non-primary residential and multi-line business lines, we conclude that affordability concerns do not require us to retain the current ceiling on the monthly SLC. Consequently, we raise the SLC ceiling for these lines to the level that permits incumbent LECs full recovery for their common line revenues, but never more than $3.00 above the current SLC ceiling for multi-line business lines today, adjusted for inflation.[43] Almost all subscribers will pay SLCs below, and often substantially below, the ceiling. The increase in the SLC ceiling for multi-line businesses will be implemented in the first year. To ameliorate the impact that a dramatic increase in the SLC ceiling might have on residential customers, however, the increase for non-primary residential lines will be phased in over time. The data indicate that raising the SLC ceiling to this level will permit incumbent price cap LECs to recover their average common line revenues from 99 percent of their non-primary residential and multi-line business lines.[44] For the remaining lines, many of which are located in rural areas, the SLC ceiling for non-primary residential and multi-line business lines will ensure that end-user charges are not prohibitive or significantly above the national average,[45] thereby advancing universal service goals of affordability and access.

40. In summary, the plan we adopt here phases out significant implicit subsidies in the access charge rate structure, while taking into account universal service concerns of affordability and access. The resulting rate structure is more closely aligned with cost principles. Under this plan, most price cap incumbent LECs will recover their interstate common line revenues through flat-rated SLCs and PICCs.

41. *Switching and Transport Charges.* Following the same pricing principle that flat charges should recover fixed costs and variable charges should recover variable costs, we

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[42] To the extent that the PICC ceiling prevents full recovery of average per-line common line revenues for primary residential and single-line business lines, the residual amount will be recovered through the PICC imposed upon non-primary residential and multi-line business lines. As described in Section III.A below, as the PICC associated with primary residential and single-line business lines increases, the amount of common line revenues associated with those lines that is recovered through the PICC imposed upon non-primary residential and multi-line business lines will fall to zero.

[43] The $3.00 increase in the SLC cap for these lines is measured on a per-month basis.

[44] *See* Supporting Material filed with 1996 Annual Access Tariff Filing, filed with Commission on April 2, 1996. This LEC forecast data were used by LECs to set SLC rates that became effective on July 1, 1996.

[45] We have also taken account of concerns raised by rural carriers and consumers groups that the increase in the SLC for non-primary residential lines and multi-lines could lead to substantial price increases in rural areas. Consequently, we are adopting these changes only for price cap incumbent LECs and will review rate structure modifications affecting small, rural carriers in a separate proceeding. *See* Section V.B, *infra.*

make several modifications to the rate structure for switching and transport services. Among other things, we move the cost of line-side ports to the common line and require their recovery through flat-rated charges. To the extent permitted by the record, we also direct incumbent LECs to reassign costs in the Transport Interconnection Charge (TIC) in order to comply with principles of cost causation and the D.C. Circuit's recent decision in *CompTel v. FCC*.[46]

2. Baseline Rate Level Reductions

42. The rate structure changes that we implement in this Order eliminate some of the distortions that have characterized the access charge system for over a decade. These changes, however, are not alone sufficient to create a system that accurately reflects the true cost of service in all respects. To fulfill Congress's pro-competitive mandate, access charges should ultimately reflect rates that would exist in a competitive market. We recognize that competitive markets are far better than regulatory agencies at allocating resources and services efficiently for the maximum benefit of consumers. We conclude, consequently, that competition or, in the event that competition fails to develop, rates that approximate the prices that a competitive market would produce, best serve the public interest.

43. The rate restructuring we implement in this Order results in substantial reductions in the charges for usage-rated interstate access services. These reductions move these access charges a long way towards their forward-looking cost levels.[47] Furthermore, in addition to these rate structure adjustments, we also take several steps in this Order to address specific cost misallocations that cause access charges to be set above economic costs. For example, we require incumbent LECs to make an exogenous cost adjustment to reflect the full amortization of certain equal access costs. We also issue a Further Notice of Proposed Rulemaking to consider our tentative conclusion that certain General Support Facility (GSF) costs should be reallocated to detariffed services.

44. We recognize that the prescriptive measures that we implement today represent the first step toward our goal of removing implicit universal service subsidies from interstate access charges and moving such charges toward economically efficient levels. In the NPRM, we identified two separate ways to continue this process in the future -- a prescriptive approach in which we actively set rates at economic cost levels, and a market-based approach that relies on competition itself to drive access charges down to forward-looking costs. We

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[46] *Competitive Telecommunications Ass'n v. FCC*, 87 F.3d 522 (D.C. Cir. 1996).

[47] Economists recognize that substantial progress in driving prices toward forward-looking costs eliminates a disproportionate amount of economic distortion. *See, e.g.*, F. M. SCHERER AND DAVID ROSS, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 662 (1990) (observing that dead weight welfare loss "rises as a quadratic function of the relative price distortion").

conclude in this Order, based on our experience in exchange access and other telecommunications markets and the record in this proceeding, that a market-based approach to reducing interstate access charges will, in most cases, better serve the public interest. Although the Commission has considerable expertise in regulating telecommunications providers and services efficiently for the maximum benefit of consumers, we believe that emerging competition will provide a more accurate means of identifying implicit subsidies and moving access prices to economically sustainable levels. Further, as discussed above, we believe that this approach is most consistent with the pro-competitive, deregulatory policy contemplated by the 1996 Act. Accordingly, where competition is developing, it should be relied upon in the first instance to protect consumers and the public interest.

45. We acknowledge that a market-based approach under this scenario may take several years to drive costs to competitive levels. We also recognize that several commenters have urged us to move immediately to forward-looking rates by prescriptive measures utilizing forward-looking cost models. We decline to follow that suggestion for several reasons. First, as a practical matter, accurate forward-looking cost models are not available at the present time to determine the economic cost of providing access service. Because of the existence of significant joint and common costs, the development of reliable cost models may take a year or more to complete. This situation might be contrasted with that addressed in our *Local Competition Order*, where we endorsed the use of cost models to estimate the cost of providing unbundled network elements. There, we observed that unbundled elements have few joint and common costs, so that devising accurate cost models for unbundled network elements is more straightforward.[48]

46. In addition, even assuming that accurate forward-looking cost models were available, we are concerned that any attempt to move immediately to competitive prices for the remaining services would require dramatic cuts in access charges for some carriers. Such an action could result in a substantial decrease in revenue for incumbent LECs, which could prove highly disruptive to business operations, even when new explicit universal support mechanisms are taken into account. Moreover, lacking the tools for making accurate prescriptions, precipitous action could lead to significant errors in the level of access charge reductions necessary to reach competitive levels. That would further impede the development of competition in the local markets and disrupt existing services. Consequently, we strongly prefer to rely on the competitive pressures unleashed by the 1996 Act to make the necessary reductions.

47. To the extent that some commenters contend that the immediate elimination of all implicit subsidies is mandated by the 1996 Act, we disagree. Neither in the 1996 Act nor its legislative history did Congress state that all forms of implicit universal service support shall be made explicit by May 8, 1997. To the contrary, Congress stated that the conversion

[48] *Local Competition Order*, 11 FCC Rcd at 15846, ¶ 678.

of implicit subsidies to explicit support is a goal that "should be" pursued "[t]o the extent possible."[49] Congress most certainly did not state that we must reach that goal by May 8, 1997. Rather, it directed that, by that date, we issue rules that "shall include a definition of the services that are supported by Federal universal service support mechanisms and a specific timetable for implementation."[50] Our companion order satisfies that timetable, and this Order establishes a process that will eliminate some implicit subsidies quickly and more gradually eliminate others.

48. We are confident that the pro-competitive regime created by the Act and implemented in the *Local Competition Order* and numerous state decisions will generate workable competition over the next several years in many cases, and we would then expect that access price levels to be driven to competitive levels. We also recognize, however, that competition may develop at different rates in different places and that some services may prove resistant to competition. Where competition has not emerged, we reserve the right to adjust rates in the future to bring them into line with forward-looking costs. To assist us in that effort, we will require price cap LECs to submit forward-looking cost studies of their services no later than February 8, 2001, and sooner if we determine that competition is not developing sufficiently for the market-based approach to work. We anticipate that the tools needed to complete these cost studies will be available soon, well before this deadline. Indeed, our *Universal Service Order* requires comparable cost models to be ready by 1998. We will then review competitive conditions and the submitted cost studies.

49. As we acknowledged in the NPRM, a market-based approach will permit and, indeed, require us progressively to deregulate the access charge regime as competition develops. In a subsequent order, we will examine specific issues concerning the timing and degrees of pricing flexibility. That order will identify the competitive triggers that must be met to justify relaxation of specific regulatory constraints. We also recognize the need to examine whether incumbent LECs should be compensated for any historical costs that they have no reasonable opportunity to recover as a result of the transformation from a regulated to competitive marketplace. We recognize that this issue may raise difficult questions of both law and equity, and we intend to respond fully to concerns about historical cost recovery in a subsequent order to be issued this year.

50. Finally, we adopt in this Order our earlier tentative conclusion that incumbent LECs may not assess interstate access charges on information service providers (ISPs). We find that our existing policy promotes the development of the information services industry, advances the goals of the 1996 Act, and creates significant benefits for the economy and the American people. With respect to second and additional residential lines, which are often

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[49] 47 U.S.C. § 254(e); Joint Explanatory Statement at 131.

[50] 47 U.S.C. § 254(a)(2).

used by consumers to access ISPs, our goal is to move towards price levels and structures that reflect underlying costs, and thereby to create a neutral market environment in which these lines neither give nor receive subsidies. We will address fundamental questions concerning ISP usage of the public switched network as part of a broader set of issues under review in a related *Notice of Inquiry*.[51]

51. Section II of this Order provides an overview of the rate structure adjustments adopted today. Section III offers detailed explanations of these changes, which include adjustments to the rate structure for the common line, local switching, transport, SS7, and switching, and modifications to the TIC. In Section IV, we adopt a market-based approach to reducing access charges and address several specific rate level adjustments. In Section V, we determine which of the changes adopted in this Order should apply to rate-of-return LECs.

52. Section VI touches upon several additional issues, including the applicability of access charges to unbundled network elements, our treatment of terminating access, and ISPs. We also discuss modifications that may be needed to reconcile our access charge rules with the *Universal Service Order* released today. In Section VII, we issue an FNPRM to seek comment on proposals to alter the current allocation of GSF costs and to allow incumbent LECs to impose a PICC on special access lines.

II. SUMMARY OF RATE STRUCTURE CHANGES AND TRANSITIONS

53. In rationalizing the switched access rate structure in this Order, our primary goal is to ensure that traffic-sensitive costs are recovered through traffic-sensitive charges and NTS costs are recovered through flat-rated charges, wherever appropriate. Because many NTS costs are currently recovered through per-minute charges, the principal effect of our Order is to reduce the amount recovered through per-minute interstate access charges and increase the amounts recovered through flat-rated charges. We phase in these changes over time to ameliorate any disruptions these adjustments might cause end users.

A. Common Line Rate Structure Changes

54. Because the cost of using the incumbent LEC's common line does not increase with usage, the costs should be recovered through flat non-traffic-sensitive fees. In this Order we increase the amount of common line revenues recovered through flat-rated charges over time until incumbent LECs can recover all of their interstate common lines revenues through NTS fees.

[51] *See* Usage of the Public Switched Network by Information Service and Internet Access Providers, CC Docket No. 96-263, Notice of Inquiry, FCC 96-488 (rel. Dec. 24, 1996).

55. *Primary Residential and Single-Line Business Lines.* We agree with the Federal-State Joint Board on Universal Service that the SLC ceiling for primary residential and single-line business lines should not be increased, because a higher SLC could make telecommunications service unaffordable for some consumers. To the extent common line revenues cannot be recovered through the customer's existing SLC, we conclude that LECs should recover these revenues through a flat, per-line charge (the "primary interexchange carrier charge" or "PICC") assessed, not on the end user, but on the end user's presubscribed interexchange carrier.[52] We set a ceiling on the PICC at the level of existing per-line charges for the first year.

56. In order to give IXCs an opportunity to adjust to the new charge, we gradually increase the PICC ceiling over the next several years until it reaches a level that permits full recovery of common line revenues -- plus a portion of "residual TIC" revenues. To the extent that the ceiling on the primary residential and single-line business PICC does not allow for full recovery of these common line revenues immediately, the remaining revenues will be recovered through a PICC imposed upon non-primary residential and multi-line business lines, and through per-minute charges.

57. As the PICC ceiling for primary residential and single-line business lines increases, the amount of common line revenues transferred to non-primary residential and multi-line business lines will fall to zero. At that point, all common line costs for primary residential and single-line business lines will be recovered through flat-charges on those lines.

58. *Non-Primary Residential and Multi-Line Business Lines.* Because affordability concerns are not as significant for these lines, we permit a modest increase in the SLC to permit recovery of the price cap LEC's average per-line common line revenues, but never to more than $3.00 above the SLC ceiling for multi-line business lines today, adjusted for inflation. To ameliorate the impact that an increase in the SLC might have on residential customers, the increase in the SLC ceiling will be phased in for non-primary residential lines over several years.

59. We also establish a flat-rated PICC on non-primary residential and multi-line business lines. This PICC will cover common line revenues that exceed the ceilings on SLCs and primary residential PICCs.[53] We set a ceiling on this PICC in the first year of $1.50 for non-primary residential lines and $2.75 for multi-line business lines, and permit those ceilings to increase gradually thereafter. We anticipate that the actual PICC imposed upon multi-line

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[52] Where an end user does not select a presubscribed interexchange carrier, we allow a price cap LEC to collect this charge directly from the end user.

[53] It may also recover some residual TIC revenues and certain marketing expenses, as discussed below.